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B.A. Economics
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Paper-1 (Microeconomics)
Topic: Uncertainty Bearing Theory of Profit

Uncertainty Bearing Theory of Profit

Uncertainty Bearing Theory of Profit was propounded by an American economist *Prof. Frank H. Knight*. This theory, starts on the foundation of Hawley's risk bearing theory. Knight agrees with Hawley that profit is a reward for risk-taking. There are two types of risks viz. foreseeable risk and unforeseeable risk. According to Knight unforeseeable risk is called uncertainty beaming.

Knight, regards profit as the reward for bearing non-insurable risks and uncertainties. He distinguishes between insurable and non-insurable risks. Certain risks are measurable, the probability of their occurrence can be statistically calculated. The risks of fire, theft, flood and death by accident are insurable. These risks are borne by the insurance company.

The premium paid for insurance is included in the cost of production. According to Knight these foreseen risks are not genuine economic risks eligible for any remuneration of profit. In other words insurable risk does not give rise to profit.

He divides risks into two classes:

1) **Foreseeable risks and,**

2) **Unforeseeable risks.**

1. Foreseeable Risks **: These risks can be foreseen and estimated in advance. Example, fire accidents, marine accidents, theft etc. All these risks can be ensured with an insurance company. If there is any loss that insurance company pays the total value of the lost property. Thus, this kind of risks will be born by insurance companies and got by the entrepreneur. The entrepreneur gets no profits on account of these risks.**

2. *Unforeseeable Risks*: These risks cannot be foreseen and predicted accurately. According to Knight these unforeseen risks are known as uncertainties, as they cannot be known and foreseen.

Following are some of the unforeseeable risks.

1) Changes in prices due to technological changes,

2) Decrease in the demand due to changes in tastes and fashions, population, incomes etc.

3) Competition from new firms or new products,

4) Government may interfere into the affairs of the industry and fix lower prices,

5) Cyclical economic depressions resulting in lack of demand, falling prices etc.

Since these risks cannot be foreseen and estimated accurately no insurance company will be prepared to cover against them. Hence, these are called uncertainties. According to Prof. Knight there is a direct relationship between profit and uncertainty bearing. Greater the uncertainty bearing, the higher will be the level of profits and vice versa. Uncertainty hearing has become so important in business. So, uncertainty bearing is regarded as a separate factor of production. The entrepreneur himself has to bear these uncertainties. But all persons are not capable of undertaking uncertainties. So, uncertainties restrict the supply of entrepreneurs. According to Prof. Knight profit is the reward for bearing these uncertainties.

***Criticism*:**

1. According to this theory, profit is the reward for uncertainty bearing. But critics point out that sometimes an entrepreneur earns no profit in spite of uncertainty bearing.

2. Uncertainty bearing is one of the determinants of profit and it is not the only determinant. Profit is also a reward for many other activities performed by entrepreneur like initiating, coordinating and bargaining, etc.

3. It is not possible to measure uncertainty in quantitative terms as depicted in this theory.

4. In modern business corporations ownership is separate from control. Decision-making is done by the salaried managers who control and organise the corporation. Ownership rests with the shareholders who ultimately bear uncertainties of business. Knight does not separate ownership and control and this theory becomes unrealistic.

5. Uncertainty bearing cannot be looked upon as a separate factor of production like land, labour or capital. It is a psychological concept which forms part of the real cost of production.

6. Monopoly firms earn much larger profits than competitive firms and they are not due to the presence of uncertainty. This theory throws no light on monopoly profit.